

EMBARGO UNTIL 17.00 HOURS ON THURSDAY, 19TH JUNE 1980

THE CENTRAL PROBLEM OF PUBLIC EXPENDITURE

A speech to be delivered at Manchester Business School on 19th June 1980, by Professor Douglas C. Hague, Deputy Director, Manchester Business School [and adviser to the Prime Minister's Policy Unit at 10 Downing Street.]

A basic characteristic of the public sector appears to be that productivity rises more slowly than in the private. It is not easy to measure, or to increase, the "output" of a civil servant, a teacher or a nurse. In parts of the public sector productivity does increase, but there are many where it does not. There statements are tentative because it is so difficult to measure public sector productivity. Official statistics show that the price of a given volume of public sector current output - which comprises central and local administration and services, education, health, defence, etc - rises more quickly than the price of output in general. This is what economists call the relative price effect. The implication is that private sector productivity rises faster than public. These government figures are, however, based on the assumption that there is no increase in public sector productivity, which seems too pessimistic.

Another characteristic of the public sector is that there is a limit beyond which taxation cannot be increased. If it is, some people evade it; others restrict the work they do. And electorates look for lower, not higher, taxes. It is economically undesirable and politically impossible to raise tax rates in the UK above present levels.

I here develop a method to indicate what would happen if public sector productivity rose 2% per annum faster than in the private sector, in which I include the nationalised industries. Since we do not know how realistic this assumption is, I then consider what has happened in the UK since 1957, to see whether my conclusions seem plausible.

I assume that, initially, national output is 100. Out of this, 25 is from the public sector and 75 from the private. There is full "comparability" in public sector pay. Everyone is paid the full rate made possible by private sector productivity, but I assume no rise at all in productivity in the public sector.

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There are at all times just 100 units of labour. Output per unit of labour is therefore initially one unit per annum, with 25% of the labour force in the public sector and 75% in the private. The only tax is a flat-rate one on all output (expenditure). The rate is initially 25%, that required to pay the 25% of the working population who are in the public sector.

Results

After 20 years, national output has risen from 100 to 136 units per annum. If there has been no movement of labour to or from the public sector, its output will still be 25. Private sector output will have risen by 2% per annum, from 75 to 111. Since everyone gets the full pay increase made possible by the rise in private sector productivity, unit pay rises from 1.00 to 1.48. Total pay is 148, of which the public sector takes 37 (25 x 1.48). The tax rate remains 25%. That rate on the pay of 148 yields the necessary 37 units.

There is, however, an important change. Instead of representing 25% of output as they did 20 years earlier, the 25 units of public sector activity now account for only 18%. This is what keeps the tax rate at 25%, even though the relative price effect has raised public sector costs per unit of "output" to 1.48 times private sector costs.

The electorate may accept this situation, but it may not. Now that the rest of the economy has become more prosperous, people may argue that the public services must match this improvement. It is, I suspect, precisely this kind of feeling which lies behind Galbraith's famous crack about private affluence and public squalor. And discussion in terms of the national income accounts tends to dodge the issue altogether by assuming that the output of a public sector employee is worth exactly what he is paid - a conveniently circular argument.

What happens if the public does not accept the situation? Suppose the electorate insists that the output of the public sector must rise in line with that in the private sector? The public sector will then always account for 25% of national output and, on my assumptions, after 20 years, national output will be only 132 and not 136. This is because, to produce 25% of national output, there would be 33 units of labour in the public sector, producing 33 units of output - 25% of 132. This leaves 67 units of labour in the private sector. With their output of 1.48 units each, total private sector output is 99.

The reason why national output is four units less than on the earlier assumptions is that eight units of labour have moved from the private to the public sector. Since they there produce only one unit each as against the 1.48 in the private sector, output falls by a net 0.48 units for each unit of labour that moves.

This may seem bad enough, but the relative price effect also takes its toll: output has fallen by 3%, but the tax rate has risen to 33% instead of 25%.

After a further decade, the situation is worse still. If we assume that after 30 years only 25 of the 100 units of labour are in the public sector, national output will be 161, 25 from the public sector and 136 from the private. Pay is now 1.81 and the tax rate still 25%, but the public sector now accounts for only 15% of output.

If the Government feels obliged to maintain public sector output at 25% of the total, national output will be reduced to 150, a fall of 7%. There are now 38 units of labour in the public sector, producing 38 units of output. The 62 units in the private sector have an output of 1.81 each, giving them 112 out of the national total output of 150. The reason output has fallen by 7% is again lower productivity in the public sector. The tax rate is 38%.

If the process continued over a full 50 years, and if public sector output was held at 25% of total output, 47% of the labour force would then be in the public sector. The tax rate, at 47%, would be almost twice that of 50 years earlier. Output would be 189, 17% lower than if public sector output had been held at 25 units, but then it would have represented only 11% of total output. And, for the record, after 100 years, the tax rate would be 71%. 71% of the labour force would be in the public sector. Output would be as much as 50% less than if public sector output had been held at 25 units. If this were a real-world economy, it would be in ruins.

Hague's Law, then, is this. If we hold the proportion of output coming from the public sector constant, then, if private sector productivity rises faster than public, pay comparability means that tax rates will rise inexorably. They will ultimately become unacceptable. We have designed an arrangement for destroying the economy.

No one is certain whether there actually is a 2% productivity gap between the public and private sectors. Does experience in the UK suggest that the dangers I have highlighted are real?

Chart I considers the relationship in the UK, between 1957 and 1979, between real GDP per head and the proportion of GDP at market prices accounted for by central and local government current expenditure on goods and services.

For the period 1957-73, the relationship is shown by the trend line in Chart I. Government spending rose fairly slowly, as GDP per head rose. In 1957, 1962, 1967 and 1972 however, things went sufficiently wrong for the government to act. In 1962 and 1972, pay policies were introduced. In 1957 public spending was cut. In 1967 the pound was devalued and the IMF insisted on public spending cuts. Significantly, there is a consistent relationship between all these years. They are on, or just outside, the "danger line" in Chart I. In one way or another, public spending had to be reduced. It may be accidental that the trend line and danger line cross about 1973. What is certain is that after the 1972-74 pay controls were ended, the explosion in public sector pay helped to move us into the "disaster area". We are still struggling to escape from it.

In 1957 to 1959, public expenditure cuts and periods of faster growth have, at intervals, moved us back to lower levels of government spending but, as in 1964 - 67, 1969-72 and 1973-75, government expenditure then grew again.

Since we cannot accurately measure changes in the volume of public sector activity, it is impossible to say exactly how much of explosion in public spending since 1973 was due to rising volumes of activity and how much to the relative price effect. The role played in 1957 to 1979 by the imposition and removal of pay controls suggests that relative price changes between the public and private sectors have been a major influence, as I have predicted.

One can also add that, if the gap between increases in public sector and private sector productivity growth is smaller than my assumed 2%, this means only that the process I have outlined takes longer. It still exists.

This analysis shows how serious the problem of public expenditure really is. Behind all the politics, there is an inexorable economic process at work. We have to recognise it and learn how to halt it. Or it will overwhelm us. Fifty years may seem a long time to wait for serious effects, but the Welfare State was born around 1945. We are already into the fourth decade of a process like that outlined here.

Qualifications

Obviously there are qualifications to such a simple analysis, but in Britain today they may make the situation worse, not better. It is true that the proportion of the working population in the public sector is only around 23% but in 1964 it was only 15%. Moreover, the model ignores transfer payments - pensions, social security benefits, etc. These are an important element in taxation, representing about 24% of current Government expenditure in 1978.

The analysis takes no account of three other important facts. First, as tax rates rise, evasion is likely to increase and taxes have to rise even further. Second, the host of bodies and individuals who set pay in the public sector may raise some pay too far. Third, partly because of the process I have outlined, successive governments have cut public spending. It has often been easier to cut capital rather than current spending, so that less has been spent on railways, roads, hospitals and so on. The result is that Britain looks increasingly down at heel.

The analysis also ignores the fact that many of the services like health-care and education which, with increasing affluence, people demand on an increasing scale, are provided largely by the public sector. A market economy would deal with the consequences by rationing the services through price and/or by forcing radical changes in the way they are provided.

In a market system, people would be provided with the services only if they paid for them. The problem in Britain is that, since public sector services are provided through the tax system, people can separate the choice whether to use the service from choices about taxation. The problem is simple. There is an upper limit to taxes. Yet the taxes pay increasingly for services which are not only becoming more expensive but, with growing affluence, are being demanded on an increasing scale. This inherent contradiction lies at the root of our difficulties.

The discussion so far has ignored inflation, but that is an advantage. One of the biggest obstacles to rational public debate on state spending is that money is no longer a reliable measuring rod. Even those who try to avoid being confused by arguments in terms of "funny money" often fail.

Closer inspection of my results shows that the relative price effect itself generates inflation. Initially, 100 units of output cost 100. After 20 years, on our "worse case", 132 units cost 148. Unit cost has risen by 12% over 20 years. The reason is that public sector pay is linked to productivity in the private sector, and not to average productivity over the economy, including the public sector. Moreover, this inflation accelerates. In years 21 to 30, price increases average less than one per cent per annum. In years 41 to 50, average inflation is 1.4% and it is rising exponentially.

There must be a similar inflationary mechanism at work in the real world. Indeed, it may be stronger. If price increases cause those in the private sector to claim higher pay to offset them, a leapfrogging process may begin. This maybe one cause of our periodic pay explosions.

It may be argued that Hague's Law gives too much emphasis to what happened in the 1950s and 1960s. Slower growth of productivity in the 1970s has held back the process I have described. Yet, even if productivity in manufacturing does not pick up soon, we seem to be on the verge of changes which will bring big increases in productivity in services, like banking through mechanisation. In any case, the government can hardly base its strategy on the assumption that its central policy - the improvement of performance and productivity in the private sector - will fail.

Tentative conclusions about what is going on in France, West Germany, Belgium and the Netherlands can be drawn from Chart II. There seems to be a fairly consistent relationship in these countries between the level of real GDP per head and the percentage of GDP spent by the government on goods and services on current account. The higher GDP per head, the bigger the government's share in total activity. But the rise is a moderate one. The UK seems to be the odd man out: it is trying to get ahead of the game. We have more government spending on goods and services than it seems these countries would have had at our standard of living. Quite simply, we are trying to sustain a German ratio of public to private activity with a much smaller GDP per head.

To move fully into line with these countries would require public expenditure cuts, at present, of at least 15%. This is not, repeat not, a call for an immediate cut of that size. Any transition towards the relationship between public and private spending that has proved so successful for these major partners and competitors would take time. But the figure I have quoted does suggest that the changes required in the structure of the British economy may be dramatic.

Consequences

There are only two possible courses of action and we must pursue them both. We must increase productivity throughout the public sector - even in fields like education where productivity is not so much a dirty word as an unknown one.

Because success in this is at best problematical, we must at the same time start a public debate on the issues raised here. We must convince all but the hard core of the Left, and even them if possible, that if we are to have tolerable rates of tax and acceptable rates of growth, we have to make radical changes. We shall have to abandon ~~many~~ public sector activities where productivity cannot be increased; charge for them; or turn them over to the private sector. And even where productivity can be increased, this may not happen unless we move some of those activities, too, into the private sector. We may also need to find ways to alter the tax and social security systems to protect the poor and disadvantaged. But the first priority is to set off a public discussion.

Conclusion

This model shows the remarkable power of an economic process. Hague's Law is not a matter of politics, but of mathematics. The process in practice is less smooth than in the model, but it is equally powerful. As Tim Congdon recently pointed out in The Times, pay policies operate in the UK by enabling us to "con" the public sector. For a year or two, we force public sector pay to fall behind what full comparability with the private sector would give. Then, as in 1974-5 and 1979-80, the inevitable pay explosion occurs, led by the public sector.

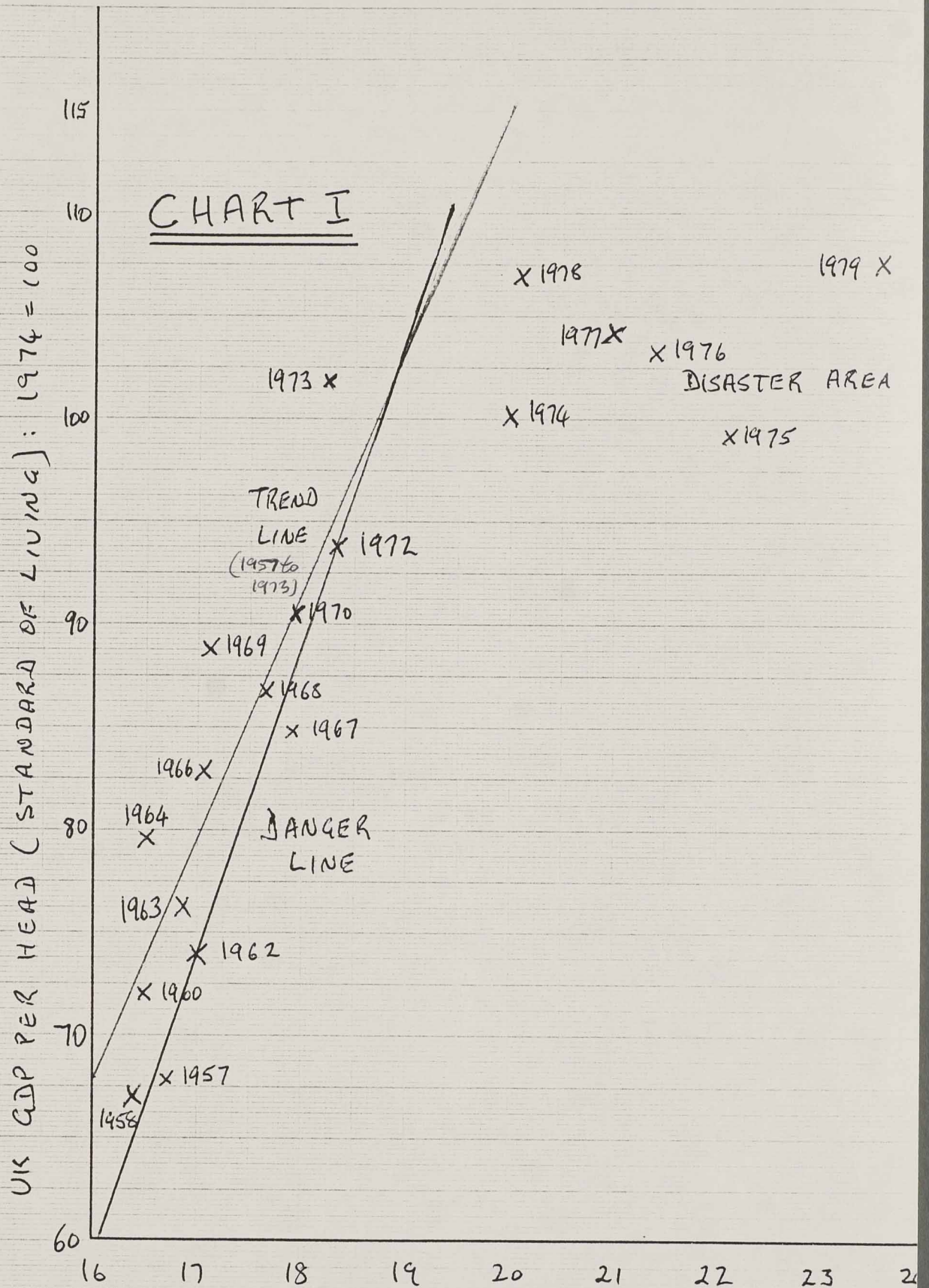
The lesson is that we must take a totally new look at the problem of public spending. De-indexing the public sector, though it might represent a holding operation, cannot halt a relentless process like this. The process has to be stopped in its tracks. De-indexing could give us only time, and perhaps not much even of that.

If so, that strengthens the need to transform the public sector. We must raise productivity where we can, and abandon entirely, or make private, those activities where we cannot. Perhaps in education, health and local government services the emphasis should be on raising "productivity" in as humane a way as possible. Since we must also make room for an increase in the Government's capital spending, it is important to begin to dismantle the bureaucracies of central and local government. But the big numbers are employed in health and education, which also have their own bureaucracies. Major changes in the way health and education are provided will be needed as time passes.

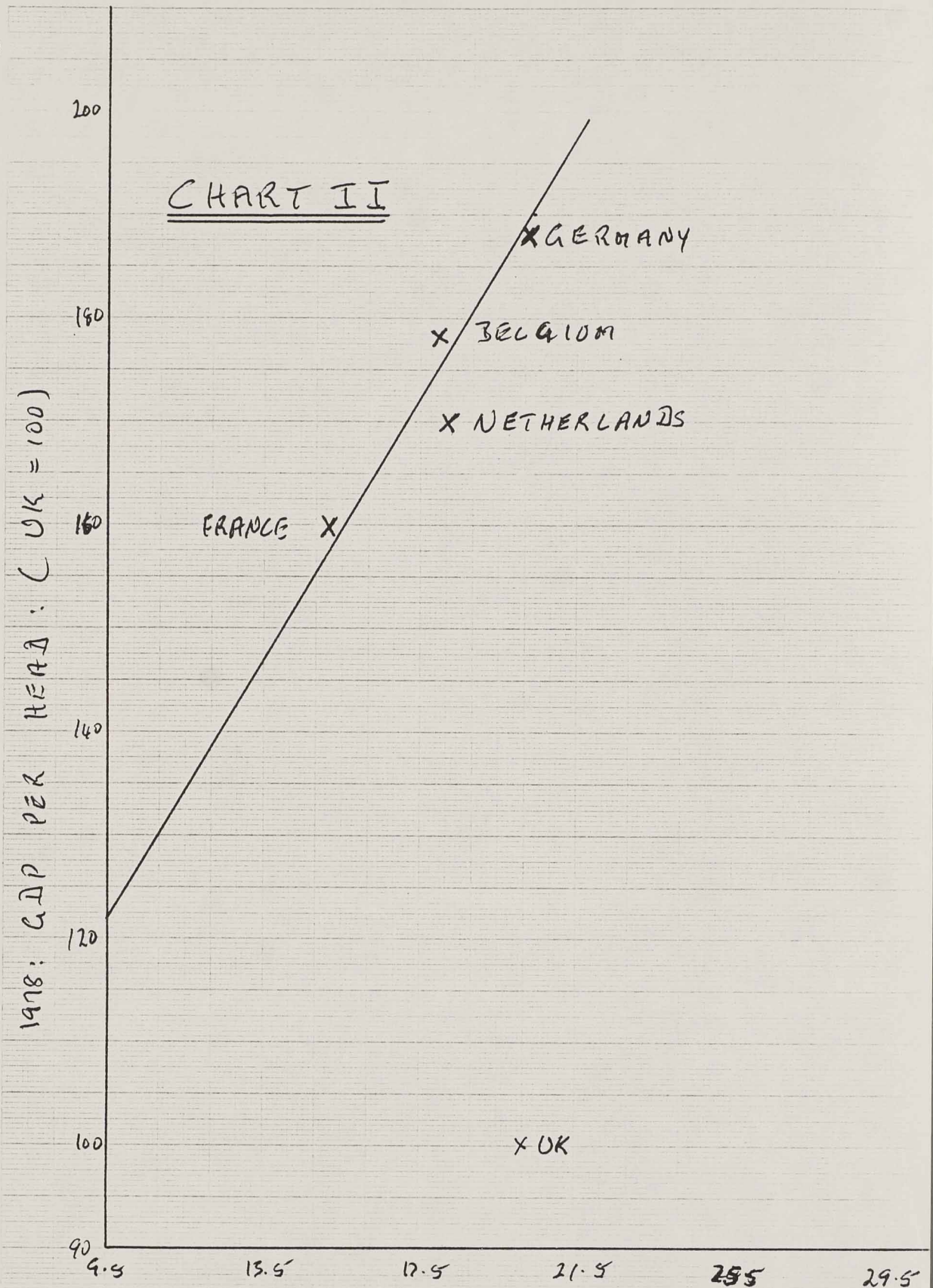
Without radical action, continuing inflation and rising taxation will destroy us. The White Paper on Government Expenditure is absolutely right: Public expenditure lies at the very heart of our economic difficulties. In creating the Welfare State in its present form we have, with the best of intentions, but with appalling lack of foresight, built the ultimate Doomsday Machine.

The lesson is that we must stop regarding cuts in the level of Government activity as isolated events. Where private sector productivity rises faster than public, the volume of public activity must be cut, not once-and-for-all, but progressively. Or tax rates will rise. We must do all we can to increase efficiency in the public sector, but it would be foolish to pin all our hopes on this. My belief is that public expenditure reductions will in future represent a normal and continuing process. This is not a matter of political ideology, but of the facts of life. We have to work out how to live with their consequences.

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UK GENERAL GOVERNMENT CURRENT EXPENDITURE ON GOODS AND SERVICES, AT MARKET PRICES, AS A PERCENTAGE OF GDP



1978: CURRENT GOVERNMENT EXPENDITURE ON GOODS AND SERVICES, AT MARKET PRICES, AS A PERCENTAGE OF GDP

Chart 1. Relative rates of inflation, public authorities' consumption and GDP, 1962-1963 to 1980-1981

